No. 12,391

IN THE

United States Court of Appeals

For the Ninth Circuit

AGNES M. KANNE, Executrix under the Will and of the Estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, *Appellant,*

vs.

AMERICAN FACTORS, LIMITED (an Hawaiian corporation), *Appellee,*

and

AMERICAN FACTORS, LIMITED (an Hawaiian corporation), *Appellant,*

vs.

AGNES M. KANNE, Executrix under the Will and of the Estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, *Appellee.*

Upon Appeal from the United States District Court for the Territory of Hawaii.

ANSWERING BRIEF ON APPEAL OF AGNES M. KANNE AND REPLY BRIEF ON APPEAL OF AMERICAN FACTORS, LIMITED.

URBAN E. WILD,
MILTON CADES,
Bishop Trust Building, Honolulu 10, T. H.,
Attorneys for Appellant, American Factors, Limited.

SMITH, WILD, BEEBE & CADES,

Subject Index

Table of Authorities Cited

No. 12,391

IN THE

United States Court of Appeals

For the Ninth Circuit

AGNES M. KANNE, Executrix under the Will and of the Estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, *Appellant,*

vs.

AMERICAN FACTORS, LIMITED (an Hawaiian corporation), *Appellee,*

and

AMERICAN FACTORS, LIMITED (an Hawaiian corporation), *Appellant,*

vs.

AGNES M. KANNE, Executrix under the Will and of the Estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, *Appellee.*

Upon Appeal from the United States District Court for the Territory of Hawaii.

ANSWERING BRIEF ON APPEAL OF AGNES M. KANNE AND REPLY BRIEF ON APPEAL OF AMERICAN FACTORS, LIMITED.

A statement of the pleadings and facts disclosing the basis upon which it is contended that the District

Court had jurisdiction and that this Court has jurisdiction to review the judgment is set forth on page 2 of brief for appellant, American Factors, Limited, and on page 2 of brief for Agnes M. Kanne.

A statement of the case, presenting the questions involved and the manner in which they are raised, is set forth on pages 3 to 25 of brief for appellant, American Factors, Limited. The statement of the case sets forth a summary of the facts with regard to the appeals of both American Factors, Limited, and Agnes M. Kanne.

The appeal of Agnes M. Kanne raises the one issue of whether the taxpayer is entitled to deduct in 1932 the sum of $171,795.26 of the Hackfeld litigation expenses as expenses accruing in that year. Of this amount it is claimed by counsel for Agnes M. Kanne that with respect to the sum of $83,802.76, which was paid by the taxpayer prior to 1932, the expense therefor necessarily had accrued before being paid and, consequently, was not incurred or accrued in 1932. Further, it is contended that there is no proof that the amounts paid prior to 1932 were to cover services performed or expenses to be incurred in 1932. With respect to the balance thereof, in the amount of $87,992.50, which was paid in 1932, it is contended that the taxpayer has failed, for lack of proof, to establish that said expenses were incurred and accrued in 1932.

On its appeal American Factors, Limited, raises two issues. First, whether it is entitled to the deduction, as an ordinary and necessary expense of carry-

ing on its business in the computation of its income tax liability for the year 1932, of $396,812.50 of Hackfeld litigation expenses, which amount was reimbursed to its co-defendants in the year 1932. Second, whether it is entitled to a deduction, in the computation of its income tax liability for the year 1932, of the amount of $50,000.00 advanced by it to Waterhouse Company and charged off as worthless in the year 1932, as a bad debt, as an ordinary and necessary expense of carrying on its business, or as a loss sustained in the year 1932.

With respect to the issues raised by American Factors, Limited, it is contended by counsel for Agnes M. Kanne that that portion of the litigation expense, in the sum of $396,812.50, was not incurred in carrying on the taxpayer's business and was not an ordinary and necessary expense of the taxpayer's business and, further, that it did not accrue in 1932.

It is the contention of counsel for Agnes M. Kanne, with respect to the deductibility of the sum of $50,000.00 advanced to Henry Waterhouse Trust Company, that it is not deductible as a bad debt because the note received by it was not payable at all events, but its payment was contingent on the debtor having funds to pay it after all its other liabilities and expenses had been paid, that being contributed to serve the community generally and without expectation of repayment it did not constitute a debt sufficient to support a bad debt deduction, and, in any event, taxpayer failed to prove facts sufficient to enable the Court to determine that taxpayer's ascertainment of

worthlessness was based on sufficient facts to warrant the deduction. Further, that taxpayer did not deem the debt worthless since it declined to concede its worthlessness.

The further contention is made that the payment is not deductible as a loss because it was a voluntary contribution and even if there was a loss it could not be deducted in 1932. Further, that it was not an ordinary and necessary business expense in 1932 and, even if it were, it was incurred and paid in 1931 and could not be deducted in 1932.

ARGUMENT.

I.

TAXPAYER IS ENTITLED TO DEDUCT IN 1932, AS AN ORDINARY AND NECESSARY BUSINESS EXPENSE, $568,607.76 OF THE HACKFELD LITIGATION EXPENSES, REPRESENTING $171,795.26 PAID BY IT AND ALLOWED AS A DEDUCTION BY THE DISTRICT COURT, AND $396,812.50 REIMBURSED TO OTHER DEFENDANTS AND DISALLOWED BY THE DISTRICT COURT.

The opinion of the Court below, with respect to the deductibility of the Hackfeld litigation expense, is in part as follows:

> "Certainly, the taxpayer had very substantial interests to protect, and was justified in every way, as a legitimate business outlay, in paying from its own funds during the taxable year of 1932, or earlier years had it chosen to do so, the costs of litigation which imperiled its existence although others were involved in the same litigation as defendants and had much to lose, had the

others not come forward with funds and volunteered to engineer and fight the battle at their own costs and had the taxpayer not accepted this offered payment plan and the volunteered services; either of the parties could have abandoned or modified this plan at any time, but so long as it was adhered to it was binding on both; but the taxpayer was not justified, in the realm of taxation laws and deductibles, to later deduct from taxable income the money it paid to reimburse voluntary contributors for money which they had paid out to clear themselves and this company of fraudulent charges made against them collectively and individually and to protect their property interests, no matter if victory in such defense brought great benefit to the taxpayer as well as to the other named defendants.

As between share owners, of course, within ultra vires limitations, they were empowered to make any desired distribution of the company's funds so long as none was injured.

The taxpayer is entitled to an expense-deduction in its 1932 tax return of the sum of all Hackfeld litigation paid by it prior to the end of 1932, less the amount paid in to it for that purpose by the other defendants. The claim for tax refund on sums reimbursed to voluntary contributors to this litigation fund is denied." (R. 63-64.)

The gist of this opinion is that although taxpayer had substantial interests to protect and was justified in every way, as a legitimate business expense, to pay expenses of litigation which imperiled its existence although others were involved in the same litigation as defendants, it could only deduct in 1932 such expenses,

regardless of when paid by it, as were not paid in to it for that purpose by the other defendants.

It is the contention of taxpayer that the Court correctly ruled that all the Hackfeld litigation expenses are ordinary and necessary business expenses, and that regardless of when paid, the entire amount accrued in 1932 when all the events determining the liability therefor had occurred, but erred in its finding that American Factors, Limited, could not deduct the amounts originally paid in by the other defendants, when the taxpayer reimbursed said other defendants when its liability therefor became certain.

(A) TAXPAYER IS ENTITLED TO DEDUCT $171,795.26, REPRESENTING THE PART OF THE HACKFELD LITIGATION EXPENSES PAID BY IT AND ALLOWED AS A DEDUCTION BY THE DISTRICT COURT.

The entire argument of counsel for Agnes M. Kanne in regard to the deductibility of the Hackfeld litigation expense is based on the assumption that the costs of litigation were apportioned or prorated between the taxpayer on the one hand and the co-defendants on the other hand. There is no basis for such an assumption and the record shows conclusively that such was not the fact.

The record shows that the taxpayer was not a party to the written agreement dated July 28, 1924 (Exh. 1 of Plaintiff's Exh. P-5, R. 202-204), wherein the co-defendants agreed to prorate, on an original per share basis, the expenses of the threatened litigation if they were joined as defendants therein. American Factors was not a party to said agreement (R.

186-187). An examination of the agreement itself shows that said co-defendants, other than American Factors, agreed to contribute and pay on demand such a proportion of *all* of the costs and expenses of every description on a per share basis as may have been already paid or incurred, or shall or may thereafter be paid in connection with the Hackfeld litigation by Allen W. T. Bottomley, C. R. Hemenway, F. C. Atherton and R. A. Cooke acting for all of them (R. 202-203).

The evidence shows that the method followed was that American Factors, Limited, acting as banker for the committee, paid bills approved by it and, when a certain amount of expenses had been incurred, an assessment would be levied, divided by the number of shares, and collections would be made from each of the co-defendants on a per share assessment basis (R. 256-257, 291).

An examination of the Plaintiff's Exh. P-7 (R. 262-275) and Plaintiff's Exh. P-8 (R. 308-310) will disclose that in the year 1924 there was paid by American Factors $108,450.65, and there was assessed against the co-defendants and collected the amount of $75,-937.50. For the year 1925, there was expended $198,114.32, or a total to December 31, 1925, of $306,-564.97. As can be seen from Exh. P-8, the last assessment was made in December, 1925, and the total amount paid in the year 1925 by the other co-defendants was $279,987.50, so that at the end of 1925, although American Factors had paid out only $306,564.97, it had received from its co-defendants

$351,925.00. In addition, it received on January 4, 1926, $9,500.00 from A. W. T. Bottomley, on January 5, 1926, $8,787.50 from George Sherman, and on January 19, 1926, $21,850.00 from Welch & Co., making the total received by it on account of the assessments made as of prior to the close of 1925, $396,812.50. This was at a time when its total expenditures were only $306,564.97. On January 19, 1926, it paid Oscar Sutro a fee of $100,000.00, so that as of the date of the receipt of the last payment from any of the co-defendants, the total expenditure by American Factors was $406,564.97, or less than $10,000.00 more than the total paid in.

It is quite obvious that the statement of the Treasurer of the company (R. 256-257, 291) as to the method of determining the amounts to be assessed to the co-defendants is borne out by the record. It is clear that up to this time the co-defendants had paid in to taxpayer practically the full amount of the expenses paid.

It is also apparent that the assessments made against the co-defendants on a per share basis were made before the decision of the trial judge of the Superior Court of California on January 6, 1926. Once the case had been decided by the trial judge, the amount of the additional payments made for Hackfeld litigation expenses in the years prior to 1932 was not very large. No further assessments were made against the co-defendants thereafter. If the judgment of the trial Court did not stand up, there was time enough then to collect from its co-

defendants the amounts paid for said litigation expenses. The very fact that all of the expenses through 1925 and prior to the judgment by the trial Court were paid by the co-defendants militates very strongly against any finding or presumption that there was any apportionment between American Factors and the other co-defendants as to the shares of the expenses to be borne by each.

There is no evidence of and there was at no time any agreement as to the prorating of the litigation expenses as between American Factors on the one hand and the co-defendants on the other. The only agreement as to prorating was among the co-defendants themselves, so that if they were finally determined to be liable therefor, they would share the expenses pro rata on an original subscription per share basis. The question as to whether or not the co-defendants or American Factors would ultimately pay the expenses of litigation was not determined until after the final conclusion of the litigation (R. 205, 280-283, 289).

The sum of $171,795.26 represents the portion of the Hackfeld litigation expense paid by American Factors upon the approval of the committee of the co-defendants after the final assessment among the members of the group on a per share basis was made and the amounts paid in.

The District Court, determining that all the expenditures, totalling $568,607.76, accrued in 1932 and would be ordinary and necessary business expenses in 1932 had not a portion thereof been voluntarily paid

by the co-defendants, held that American Factors could deduct only the amount not paid in by others in the first instance, but could not deduct the amount so paid by others and voluntarily reimbursed by American Factors to such co-defendants without demand or test of their right to reimbursement and in the absence of a promise or implied intention to reimburse them at the time they made their contribution toward the expenses of the litigation.

With respect to the portion thereof, in the amount of $83,802.76, paid prior to 1932, it is contended by counsel for Agnes M. Kanne that since this amount was paid prior to 1932 it is not possible to conclude that this amount accrued in 1932. In support thereof, the case of *Chestnut Securities Co. v. United States,* 62 F. Supp. 574, is cited. This case has no relation to the present issue. As between a debtor and creditor, the payment to the creditor may constitute such payment an accrual of the liability at the time of payment. Certainly, when a debtor discharges a debt by payment, the expense may have accrued as to the debtor. But here we are concerned with the question as to who the debtor is, that is, which of two persons will ultimately bear the liability for an amount already paid. Here is a case where liabilities were incurred and were paid, but the ultimate question as to whose liability those payments constituted was not and could not be settled until the final determination of the litigation which it is conceded occurred in 1932.

As set forth in the cases of *United States v. Anderson,* 269 U.S. 422, 70 L. ed. 347, and *Brown v. Helver-*

ing, 291 U.S. 193, 78 L. ed. 725, cited by counsel for Agnes M. Kanne (Br. p. 16), an expense accrues for deduction at the time the events occur which determine the liability of a taxpayer to pay and fix the amount. It is quite obvious that all the events did not and could not have occurred prior to 1932 which would determine whether the liability was that of American Factors or the other co-defendants. There is no question that one or the other must pay and, for convenience, American Factors acted as banker and did pay, but the determination of which was ultimately to be responsible therefor could not be fixed in any year prior to 1932, and that is the final event on the happening of which the liability accrued and became deductible.

With respect to the amount of $87,992.50 paid in 1932, counsel for Agnes M. Kanne relies on the fact that no showing was made that the services were rendered in 1932 and the presumption is that they undoubtedly accrued in prior years. With respect to this amount, there is no difference between that and any other portion of the amount. It is not a question of when the services were rendered, or when the services were paid for, it is merely a question of when it could finally be determined which of the parties were liable for the payment therefor. Further, in any event, with respect to the fee of $85,000.00 paid to Oscar Sutro on July 28, 1932, it must be apparent that the expense therefor did not accrue until the amount thereof was fixed and the bill was submitted, and it is submitted that in no event can this amount be disallowed as a deduction in 1932.

(B) THE DISTRICT COURT ERRED IN DISALLOWING THE DEDUCTION AS AN ORDINARY BUSINESS EXPENSE IN 1932, BY AMERICAN FACTORS, LIMITED, OF $396,812.50 OF HACKFELD LITIGATION EXPENSES REIMBURSED TO OTHER DEFENDANTS.

As pointed out above, the entire argument of counsel for Agnes M. Kanne in regard to the deductibility of the Hackfeld litigation expense is based on the erroneous assumption that the costs of litigation were apportioned or prorated between American Factors, Limited, on one hand and the co-defendants on the other. This erroneous assumption has colored all the arguments presented so that the cases presented, when applied to the real facts, sustain the contentions of taxpayer.

(a) The amount was paid or incurred in carrying on the taxpayer's business.

The Hackfeld litigation had to do with charges and claims against the taxpayer, which charges were based primarily upon charges of fraud and conspiracy alleged against the taxpayer and the co-defendants acting for and on behalf of the corporation. It would have been impossible for the corporation to defend itself against the charges and the claims against it without establishing the innocence of the other co-defendants who were the officers and agents of the corporation whose alleged misconduct had to be established in order to sustain the claim against the corporation and with whom the corporation was alleged to have conspired. Therefore, the expenditures made by the corporation in defense of these claims were on its own behalf and were directly connected with its trade and

business. This the Court found, as evidenced by the statement from its opinion hereinabove cited, that such expenses would have been deductible if the co-defendants had not voluntarily paid them in the first instance. Accordingly, on this point, it must be held that the amount so paid was incurred in carrying on the taxpayer's business.

In *Hales-Mullaly, Inc. v. Commissioner,* 131 F. (2d) 509, as pointed out in the footnote on page 22 of the brief for Agnes M. Kanne, the taxpayer's liability arose solely from its receiving and retaining the benefits of the fraud of the individuals who organized it, while in the present case damages were also claimed against the corporate taxpayer as a result of its mismanagement after its organization and while engaged in business of the business and assets acquired from Hackfeld. This would suffice to show that that case is not in point here.

This all-important distinction is sought to be avoided by reliance on the fact that here the total expenses of the litigation were apportioned between the stockholder-incorporators and the taxpayer. As we have pointed out before, this is not true.

The case of *Blackwell Oil & Gas Co. v. Commissioner,* 60 F. (2d) 257 (C.A. 10th), cited on page 22 of the brief for Agnes M. Kanne, involved the deductibility by a corporation of litigation costs and amounts paid in settlement of two suits, one of which was against the corporation to recover possession of titles to certain lands as well as for profits and damages for waste. With regard to the deductibility of the amount

paid in compromise of the action against the corporation, the Court held that the action was in defense of title and, to such extent, the expenditures therefor could not be deducted, but constituted a capital expenditure. In the present case it must be remembered that the complaint in the Hackfeld litigation affirmed the acquisition of the assets of Hackfeld & Company by American Factors, Limited, and the suit was merely one for damages. The other action in the *Blackwell* case, *supra,* was against directors and principal stockholders of the corporation alleging an unlawful conspiracy among them. The corporation was not a defendant. As pointed out in the brief for American Factors, Limited (pp. 40-41), the Court, in denying the deductibility by the corporation of the amounts paid in settlement, held that since the gist of the action was unlawful conspiracy the corporation was not liable for the payments in settlement.

The case of *Knight-Campbell Music Co. v. Commissioner,* 155 F. (2d) 837 (C.A. 10th), cited on page 22 of brief for Agnes M. Kanne, involved the deductibility of attorneys' fees paid by the corporation to attorneys for common stockholders arising out of a suit between the preferred and common stockholders which was settled. The only way in which the corporation was involved was that receivership proceedings were initiated by the preferred stockholders to enforce the judgment against the common stockholders. Certainly the facts are in no way helpful to the determination of the present case.

White v. Commissioner, 61 F. (2d) 726 (C.A. 9th), cited on page 22 of brief for Agnes M. Kanne, denied

deduction by a partnership of payment in settlement of debt of a partner not connected with or growing out of the business of the partnership which it was claimed was necessary to protect creditors of the firm and to free the partnership of anxiety so he could devote himself to his duties in the partnership.

A. Giurlani & Bro. v. Commissioner, 119 F. (2d) 852 (C.A. 9th), cited on page 22 of brief for Agnes M. Kanne, denied deduction for the amount paid to the creditors of another corporation which controlled the source of supply of taxpayer's most profitable line of merchandise, which amount was paid to save said corporation from bankruptcy and preserve the source of supply of the taxpayer.

Pantages Theatre Co. v. Welch, 71 F. (2d) 68 (C.A. 9th), cited on page 22 of brief for Agnes M. Kanne, denied deduction for defense of taxpayer's President and Manager from charge of rape.

Robinson v. Commissioner, 53 F. (2d) 810 (C.A. 8th), cited on page 22 of brief for Agnes M. Kanne, denies deduction for payment of taxes on leased property where lease did not impose any obligation upon taxpayer to pay the property taxes.

Interstate Transit Lines v. Commissioner, 319 U.S. 590, 87 L. ed. 1607, cited on page 22 of brief for Agnes M. Kanne, denied deduction for operating deficit of a subsidiary corporation organized to do business taxpayer was not empowered to do.

South American Gold & Platinum Co. v. Commissioner, 8 T.C. 1297, cited on page 22 of brief for Agnes M. Kanne, likewise denied deduction for payment for

legal services for settlement of dispute and claims of a subsidiary corporation.

All of these cases are ones in which the claimed deductions are not closely related to the business of a taxpayer. These cases are cited to support a contention based upon the erroneous assumption of the fact that American Factors, Limited, agreed that the co-defendants would pay a part of the expenses and, therefore, when American Factors, Limited, afterwards reimbursed the co-defendants, it was paying amounts it was not obligated to pay, but was merely volunteering to pay the liabilities of the co-defendants.

Clearly, if American Factors, Limited, had paid all the expenses in the first instance, it could not have been denied the deduction of $396,812.50 on the ground that the expenditure was not paid or incurred in carrying on its business.

(b) The expenses were ordinary and necessary.

Again, counsel for Agnes M. Kanne, in arguing that the expenses in question were not ordinary and necessary, is assuming that $396,812.50 of the litigation expenses were agreed to be paid by the co-defendants as their share of the expenses incurred. Having assumed that it was their liability, counsel then goes on to assume that the payment to the co-defendants by American Factors, Limited, of that amount is, in effect, the payment of the liabilities of others. In support of the contention that the liabilities discharged by taxpayer were the liabilities of others, *Matson Navigation Co. v. Commissioner,* 24 B.T.A. 14, is cited in a footnote on page 25 of brief for Agnes

M. Kanne. An examination of that case will show that the facts before the Board of Tax Appeals were different than the facts presented here. There the Court states that Matson Navigation Co., having agreed to prorate the expenses of the Hackfeld litigation, received and paid statements of its proportionate share to American Factors, Limited, which, in turn, paid the accounts rendered to it on account of counsel fees and litigation expenses.

> "American Factors, Ltd., as a corporation, paid no part of the expense * * * Petitioner has not been reimbursed in any way or in any amount on account of the $40,250.00 so expended" (at p. 17).

Whether the Court would have determined that the amount paid should be allowed to Matson Navigation Co. as a deduction if the fact were established, as here, that American Factors, Limited, did reimburse the amounts paid by Matson Navigation Co. as well as the others, is an open question. Certainly this case can have no bearing on determining whether American Factors could reimburse Matson Navigation Co. and the other defendants and be entitled to a deduction therefor.

None of the cases cited by counsel (Br. for Agnes M. Kanne, p. 25) are cases similar to the case here. Once it is assumed that the obligation is another's, it may follow that the payment of such liabilities of another is not generally an ordinary and necessary business expense. But none of the cases cited help to determine whether the ultimate obligation to pay the $396,812.50 was that of American Factors, Limited, or of the co-defendants.

The expenses were incurred for the entire litigation, not $396,812.50 to defend tortious acts of promoters or organizers of the corporation on one hand, and $171,795.26 to defend the corporation itself for its unlawful conspiracy and mismanagement on the other, as appears to be the argument in the brief for Agnes M. Kanne on pages 25-27. As pointed out above, the litigation expenses of defendants, both stockholder-incorporators and taxpayer, were not allocated between them in a manner not challenged as unfair or incorrect, as there alleged.

As pointed out in the brief for American Factors, Limited (pp. 39-41), the co-defendants did not voluntarily pay the expenses of litigation without expectation of reimbursement in the event that they were freed of charges of fraud and conspiracy upon the final determination of the litigation. Rather, the amounts were prorated among the co-defendants so that all would bear a fair share in the event the judgment had been against them and they were themselves liable for the expenses of litigation.

(c) The expenses did accrue as a deduction in 1932.

As pointed out in the brief for American Factors, Limited (pp. 41-51), once the litigation charging the co-defendants with fraud and conspiracy had been finally concluded holding that they were not guilty of any fraud or conspiracy, American Factors, Limited, for the first time became bound to pay the litigation expenses and to reimburse the co-defendants for the portion of the expenses paid by them amounting to $396,812.50.

The conclusion of law of the District Court (R. 101), cited on page 27 of the brief for Agnes M. Kanne, "* * * that the amount was not an ordinary and necessary expense paid or *incurred during the taxable year 1932* by plaintiff in carrying on its business," appears to have been italicized by counsel in the wrong manner. We believe the words to be italicized are "by plaintiff". This is supported by the portion of the opinion hereinabove quoted disallowing the portion of the litigation expenses paid to American Factors, Limited, for that purpose by the other defendants (R. 64).

We believe that the court erred in not allowing the amounts originally paid in by the other defendants to American Factors, Limited, as well as the balance of the expenses, for the reasons set forth hereinabove and in the brief for American Factors, Limited.

It is respectfully submitted, therefore, that the taxpayer is entitled to deduct the amount of $396,812.50, reimbursed by it to the co-defendants in 1932, in addition to the amount allowed it as a deduction in the judgment of the Court below.

II.

THE DISTRICT COURT ERRED IN DISALLOWING AMERICAN FACTORS THE DEDUCTION OF THE PAYMENT OF $50,000.00 TO WATERHOUSE COMPANY IN 1931.

With regard to the deductibility of the sum of $50,000.00 paid to Waterhouse Company in 1931, counsel for Agnes M. Kanne contend that said amount

is not deductible as a bad debt in 1932. The argument is that the note received by taxpayer was not payable at all events, but its payment was contingent on Waterhouse Company having funds to pay it after all its other liabilities and expenses had been paid. This fact, together with the fact contended for by counsel that the amount was paid as a contribution to serve the community generally and without expectation of repayment, it is said, requires the conclusion that no debt sufficient to support a deduction was created. Further, it is argued that even if a valid debt was created, the taxpayer has failed to prove facts sufficient to enable the District Court to determine whether the taxpayer's alleged ascertainment of the worthlessness of the debt in 1932 was based on facts warranting that conclusion.

It is also contended that said sum is not deductible as a loss in 1932 because a voluntary contribution is not a basis for deducting a loss at any time and, in any event, if there was a loss, it was not sustained in 1932.

In addition, it is contended that the $50,000.00 is not deductible as an ordinary and necessary business expense and, even if it were, it accrued in 1931 when it was paid and could not be deducted in 1932.

All of these matters are covered in the brief for American Factors, Limited (pp. 51-75).

(A) THE PAYMENT OF $50,000.00 DID CREATE A VALID DEBT.

Counsel for Agnes M. Kanne contend (Br. pp. 29-32) that the payment to Henry Waterhouse Trust Company did not constitute a valid debt because it was a conditional obligation and contingent as to payment. It is true that the note was repayable only out of a particular fund after other liabilities had been settled therefrom. But it still was an absolute undertaking to pay if funds remained for payment. Every note or debt is subject, with respect to payment, to the condition or contingency that the obligors have funds with which to pay. Also, we doubt that anyone would seriously challenge the validity of a second mortgage as a valid debt because it is repayable only after satisfying the prior mortgage. Merely to state the proposition argued for by counsel for Agnes M. Kanne seems to us to make apparent its fallacy.

Counsel seem to have missed, or are attempting to slide over the relevant portion of *Clay Drilling Co. v. Commissioner,* 6 T.C. 324, when it is referred to (in footnote, p. 31 of their brief) as a case having to do with whether a debt was cancelled and forgiven as a result of an agreement under which the note became payable only in the manner agreed on. The real point of the case is that the Court there held that even though the debt was, from the date of the agreement on, payable only out of commissions that might or might not be earned in the future, nevertheless it still continued to be a valid debt which could be the subject of a bad debt deduction. This was held to be so even though payable only in a special way and not

out of the debtor's general funds. The holding of the Court would have been the same even if the note, at the time it was first issued, had been payable in the manner provided in the subsequent agreement.

The case of *Western Woodwork & Lumber Co. v. Commissioner,* 6 T.C.M. 504, conceded by counsel for Agnes M. Kanne (footnote, p. 31) to hold that a note represented a debt despite the contingent nature of its payment, is not contrary to the authorities cited by counsel, as they state, nor is it incorrect.

As stated by the Tax Court in the *Clay Drilling Co.* case, *supra,* (quoted in Br. for American Factors, p. 63):

> "* * * We know of no law which is to the effect that a debt is canceled and forgiven merely because the manner of its payment is restricted and it is agreed that the debtor shall not be personally liable if the debt is not fully paid in that manner. Both parties concede that they know of no case exactly in point. Our search has not disclosed any."

We have no quarrel with the propositions of law stated that the allowance of a bad debt presupposes the existence of a valid debt arising out of a debtor-creditor relationship, and that the giving of a note or other evidence of indebtedness which may be legally enforceable is not of itself conclusive of the existence of a bona fide debt. However, we do disagree as to what kind of condition prevents an obligation from being a debt which can be the subject of a deduction. How much of a condition must there be before the obligation ceases to be a debt? Suppose it is not pay-

able for a number of years—say 5 or 10—does such condition prevent it from being a debt. Suppose its maturity date is 1000 years? Or 100, or 50, or 25? At what point does the condition cause it to fail to be a debt? Suppose it is only payable out of the proceeds of real property, or personal property, or from a special bank account, or securities deposited for liquidation. Obviously it cannot be every condition that renders an obligation not a debt. The cases cited by counsel (Br. pp. 30-31) are quite different from the case here and do not support the proposition argued for.

Shiman v. Commissioner, 60 F. (2d) 65 (C.A. 2nd), cited by counsel for the proposition that a conditional obligation does not give rise to a debt, has this to say about it:

> "* * * It has indeed been at times debated whether a conditional obligation is an obligation at all until the condition is fulfilled, but the debate is scholastic" (at p. 66).

Milton Bradley Co. v. U. S., 146 F. (2d) 541 (C.A. 1st) involved a unique claim for a bad debt deduction. There it was claimed that the amount of an overpayment of federal taxes, for which timely claim for refund, as required by the statute, had not been filed, was deductible as a bad debt at the time the period for expiration of claims for refund expired.

S. Naitove & Co. v. Commissioner, 32 F. (2d) 949 (C.A. D.C.) has no possible application to the principle for which it is cited, having to do with time of accrual of expenses.

Wolff v. Commissioner, 26 B.T.A. 622, was determined primarily on the basis that the advances to taxpayer's son and nephew for the purpose of facilitating the liquidation of the nephew's partnership business were gifts, not loans. There a rebuttable presumption existed because of the relationship which was not overcome by evidence of intent to treat the advance as a loan. There, also, the Court considered that there were several contingencies to be overcome before the obligation, if any there was in that case, was to be paid. A partnership had to be liquidated, leaving sufficient assets to pay all other creditors and petitioner, a doubtful British claim had to be successfully prosecuted and the partnership had to be advantageously and expeditiously liquidated.

There are many more conditions there, including one entirely dependent on the will of the debtor, namely, the expeditious settlement of the affairs of the partnership which must precede the payment due on the note.

The case of *J. S. Cullinan v. Commissioner,* 19 B.T.A. 930, cited in the *Milton Bradley Co.* case, *supra* (Br. for Agnes M. Kanne, p. 30), related to a claim for deduction of approximately $30,000.00. The campaign committee of a candidate for the United States Senate was seeking thirty men to contribute $5,000.00 each for campaign expenses. The petitioner contributed $5,000.00 and agreed to advance to the committee $30,000.00, believing it would be repaid out of other contributions to the campaign fund. Only a small part was obtained and returned to petitioner. The balance claimed as a bad debt was disallowed.

Eckert v. Burnet, 283 U.S. 138, 75 L.ed. 911, involved a claim for a bad debt deducted by a taxpayer on the cash basis. Petitioner and his partner were joint endorsers of notes issued by a corporation they had formed. The corporation being unable to pay, the petitioner and his partner made a settlement of their liability by giving a note to the bank and receiving the corporation's note. Each claimed the right to deduct one-half of the amount of the note given. The Court held petitioner merely exchanged his note, under which he was primarily liable, for the corporation's note on which he was secondarily liable, without any outlay of cash. No deduction was held allowable until he ultimately paid the note.

It is difficult to see how this case is applicable.

Howell v. Commissioner, 69 F. (2d) 447 (C.A. 8th), merely held that in the absence of agreement, one who indemnifies a creditor against loss from a debtor's nonperformance of an obligation does not, by payment of indemnity, acquire any remedy over against the debtor, accordingly, no debtor-creditor relationship existed.

Again, it is difficult to see the applicability of this case.

American Cigar Co. v. Commissioner, 66 F. (2d) 425 (C.A. 2nd), involved the deductibility of an advance made to a related company at the time taxpayer knew it could never be repaid.

In re Parks Est., 58 F. (2d) 965 (C.A. 2nd), involved a claim for a bad debt on account of amounts

put into bank by the president to prevent closing thereof because of treasurer's defalcations. The treasurer assigned options on coal lands and the bank assigned claims against overdrafts of depositors, but these were worthless at the time. The Court did not pass on whether these represented debts or not, but held that if they were, they did not decrease in value after the taxpayer got them and there was nothing to charge off.

These cases, to the extent that they are at all applicable, would illustrate that where the contingency as to payment is sufficient so that the probability is great that they were not intended to be paid at all, or that they certainly would not be paid, the obligation is not recognized as a debt.

The expectation of repayment existed at the time the note here in question was received, and it was based upon a reasonable examination of all the pertinent facts. This is sufficient to make the note evidence of an absolute debt, although its payment may have been deferred until after payment of other obligations out of a particular pool of assets.

There is also no disagreement with the statement that advances voluntarily made without expectation of repayment do not create a debt which can provide the basis for a bad debt deduction.

However, it is submitted, as pointed out in the brief for American Factors, Limited (pp. 58-61), that the only evidence is that there was a definite expectation that the loan would be repaid.

It should also be pointed out that we do not concede, as erroneously stated by counsel (p. 33), that the motive for advancing the money was the protection of the commercial community. Nor did the Court hold that that was the sole motive for making the loan. In any event, as pointed out (Br. p. 66), the motive would be unimportant in determining whether the payment is or is not a loan which can be the subject of a tax deduction as a bad debt.

(B) THE DEBT WAS ASCERTAINED TO BE WORTHLESS IN 1932.

As pointed out in the brief (pp. 67-68), the direct evidence of witnesses Lowrey, Linden and Castle, and the Bank Examiner's report as of December 31, 1932, are relied on to sustain the reasonableness of the ascertainment of worthlessness and the charge-off of the note in 1932. Such evidence represents the accumulated views of the persons who were charged with the duty of knowing the facts and who were in a position to find them out. Alfred Castle and Sherwood Lowrey were both members of the advisory committee which represented the noteholders and were in close touch with the liquidation of assets of Henry Waterhouse Trust Company, being consulted with respect to all important matters in connection therewith (R. 449-450, Pet.'s Exh. P-11, pp. 389-390).

With regard to the failure of the taxpayer to concede the worthlessness of the claim, as suggested by Waterhouse in 1932 (Br. for Agnes M. Kanne, p. 37), we cannot see how that would affect the matter. It is not necessary for a creditor to return to a debtor for

cancellation a note he holds against him to be enabled to charge the same off and claim deduction therefor. He may still retain his right to receive payments that only a most unusual change in circumstances might make possible.

(C) IF NOT DEDUCTIBLE AS A BAD DEBT, THE SUM OF $50,000.00, REPRESENTING THE AMOUNT PAID TO WATERHOUSE COMPANY IN 1931, WAS DEDUCTIBLE IN 1932 AS A LOSS SUSTAINED OR AS AN ORDINARY AND NECESSARY BUSINESS EXPENSE OF AMERICAN FACTORS.

It is difficult to see how the cases of *Commissioner v. Gilt Edge Textile Corp.,* 173 F. (2d) 801 (C.A. 3rd), and *Uhl Estate Co. v. Commissioner,* 116 F. (2d) 403 (C.A. 9th), support the contention of counsel (Br. p. 38) that the loss, if any, is deductible in 1931, or, as they contend, it is not deductible at all. Further, the identifiable events occurring in 1932 which fixed the loss in that year are the separate determinations in that year that the note evidencing the payment to Waterhouse Company, given in the course of the business of taxpayer, was uncollectible.

The finding by the District Court that because a balance of $190,457.35 still remained in the reserve for losses, against which further losses must be charged before there would be any impairment for the repayment of the $400,000.00 of contributions to the noteholders, there could be no loss to the noteholders in 1932, cited by counsel (Br. p. 38), is erroneous. Only the actual losses finally sustained had been charged against the reserve for losses. However, as pointed out in the Bank Examiner's report (R. pp. 553-560), a reappraisal of the assets required the setting up of

an additional reserve for losses which completely wiped out the equity of the noteholders, and indicated an additional loss by the guarantor, Bishop Trust Company, Limited.

With regard to the facts found by the Board of Tax Appeals (now The Tax Court) in *Bishop Trust Co. v. Commissioner,* 36 B.T.A. 1173, and *Bishop Trust Co. v. Commissioner,* 47 B.T.A. 737, such facts as relate to the contributions by the noteholders to Henry Waterhouse Trust Company, the reasons therefor, and the circumstances under which the loans were made, the economic condition of the Territory at the time, are all matters of which the Court may take judicial notice, as pointed out in the opening brief.

It is respectfully submitted that the District Court erred in not allowing the deduction of $50,000.00 paid to Waterhouse Trust Company as a deduction as a bad debt, as a loss sustained, or as an ordinary and necessary business expense in the year 1932.

CONCLUSION.

It is therefore respectfully submitted that American Factors, Limited, is entitled to the deduction of the amount of $396,812.50 of Hackfeld litigation expenses reimbursed to the co-defendants as an ordinary and necessary expense in computing its taxable net income for the calendar year 1932, in addition to $171,795.26 which has been allowed as a deduction by the District Court; and that American Factors, Limited, is entitled to deduct the amount of $50,000.00 advanced to Water-

house Company, which became uncollectible in 1932, as a bad debt, as a loss sustained in that year, or as an ordinary and necessary expense of doing business in that year.

Dated, Honolulu, T. H.,
June 9, 1950.

Urban E. Wild,
Milton Cades,
Attorneys for Appellant, American Factors, Limited.

Smith, Wild, Beebe & Cades,
Of Counsel.